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C O N F I D E N T I A L SECTION 01 OF 03 LAGOS 000122

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STATE FOR AF/W, INR/AA, DS/IP/AF
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TAGS: EPET ENRG PGOV NI
SUBJECT: NIGERIA: NEW GAS POLICY MAY SLOW NATURAL GAS
DEVELOPMENT

REF: 07 LAGOS 750

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Classified By: Consul General Donna Blair for reasons 1.4 (b) and (d)

¶1. (C) Summary: Nigeria's recently announced natural gas policy will likely slow development of domestic and export natural gas projects. The policy relies on cross-subsidies from commercial and industrial users for development of electrical power projects. The policy and regulation are vague in details and contradictory in places, but establish a new gas ministry, lay out a complicated government led pricing regime, and create a natural gas clearinghouse that is supposed to manage gas supply and demand. Long established up and downstream actors have resigned themselves to this new policy and are attempting to make the best of the current situation while hoping and working behind the scenes for future revisions, particularly since the new policy is not economically viable. A window of opportunity exists to assist in the development of a follow-on policy. End Summary.

¶2. (SBU) On February 7, President Yar'Adua announced a new natural gas policy and regulation designed to spur development of natural gas projects that favor domestic industries. The relatively brief policy and regulation documents (twelve and six pages respectively) are the result of over a year of work by a Nigerian National Petroleum Corporation (NNPC) group led by Dr. David Ige, NNPC's chief natural gas planner. The two documents establish a new Department of Gas within the Ministry of Energy, expand the duties of the Minister of State for Energy (Gas), detail a three tier domestic gas pricing structure, and create a strategic gas aggregator to manage Nigeria's gas supply and demand.

¶3. (C) The policy appears only tangentially connected to the Gas Master Plan (GMP), Nigeria's all-encompassing plan for developing its natural gas infrastructure. No reference is made to the Gas Master Plan directly, although the policy contains the same projected economic growth rates and gas demand forecasts as the GMP.

Natural Gas Pricing Structure

¶4. (SBU) The policy calls for a three tiered domestic gas pricing structure: a "regulated pricing regime" with a low floor price of USD 0.10 per thousand standard cubic feet (mscf) for gas destined for domestic power plants supplying residential and light commercial users; a mid level "pseudo-regulated pricing regime" that uses a net back price for industrial users such as methanol or fertilizer producers that use gas as feedstock; and a higher level "market led regime" that references the gas price to low pour fuel oil for large commercial customers such as steel plants and cement factories. All upstream producers will receive an aggregate price based on the weighted average of the total demand of the three tiers, regardless of the customer mix of an individual gas producer. So an upstream company that principally supplies gas to power customers and upstream company supplying commercial customers will both receive the same aggregate price.

¶5. (C) The rationale for the pricing structure is economically flimsy. The floor price for gas is based on NNPC estimates of the current cost to develop natural gas fields with the assumption that upstream producers can earn USD 40 per barrel from natural gas liquids associated with the gas. However, it does not take into account increasing marginal costs to develop new gas fields. The three tier structure forces commercial and industrial customers to subsidize domestic power customers. The assumption is that gas supplied at levels below the world market price will stimulate investment in commercial and industrial sectors that use natural gas and these sectors, while receiving gas at lower than world market prices, will still pay enough to raise the aggregate price of domestic natural gas. However, given the myriad of other costs associated with operating in Nigeria, it is not clear that cheap gas alone will be

sufficient to attract methanol producers, fertilizer plants, and steel foundries. Without these large commercial users, the cross subsidies will never materialize and the aggregate price upstream producers receive will remain stalled at or near the lowest price tier. For that reason, upstream producers are seeking a guaranteed aggregate price above USD 0.50 per mscf from the GON. A contact at a European natural gas company told Econoff that IOCs will press the GON to establish a securitized fund to ensure money will be available to meet a minimum agreed upon gas price. In other words, having been burnt by the GON's failure to make its cash call payments in its oil production joint ventures with the IOCs, those same companies are not willing to simply take the GON at its word that money will be there for gas.

¶6. (C) An ill-defined mechanism for transitioning to market prices is spelled out in the policy. Once the Minister determines that a "domestic saturation" point is reached in any one of the three sectors is reached, subsequent entrants into the market will pay the next higher price for gas. For instance, if the Minister determines enough fertilizer is produced in Nigeria to meet Nigeria's domestic needs, the next fertilizer manufacturer to enter the market will pay for gas under the market-led price regime instead of the lower cost pseudo-regulated regime. The policy does not elaborate on why that theoretical marginal producer would enter the market if faced with a higher gas price than its established competitors.

Strategic Gas Aggregator

¶7. (SBU) The policy also establishes a "strategic gas aggregator" (SGA) that will ensure available gas supplies meet projected demand, match upstream suppliers with downstream customers, write purchase orders for gas, and act as a financial clearinghouse for all gas purchases. Who will

comprise the SGA and how it will accomplish those tasks are not defined. As part of the SGA concept, upstream producers will be ordered to set aside part of their gas reserves strictly for domestic use. The SGA will determine annually the amount of gas reserves upstream producers must set aside based on demand forecasts generated by the ministry of gas. Failure to set aside those reserves or meet a gas call by the SGA will result in fines of USD 3.50 per mscf.

New Policy or Interim Step?

¶8. (C) It is not clear if the new policy and regulation will replace the Downstream Gas Act that had been working its way through the National Assembly or are simply an interim step. The Downstream Gas Act was a substantial piece of legislation that detailed rules for upstream, downstream and midstream operators and oriented the domestic Nigerian gas industry towards market based solutions. In a speech at an oil and gas conference in late February, President Yar'Adua announced he was pulling the act from the National Assembly and would consolidate it into one all-encompassing piece of legislation as part of the announced reform of the Nigerian National Petroleum Corporation (NNPC) (reftel). Reform of NNPC will be a hot button issue and legislation is expected to take at least a year to wind through the National Assembly. In the opinion of one senior oil company executive, even if every legislator agreed with every word of the legislation from the day it was introduced, it would still take eight months for the legislation to be passed into law.

¶9. (C) Established upstream and downstream actors have resigned themselves to this policy and are attempting to make the best of the situation. The industry trade group representing international oil companies (IOCs) recently met with NNPC in an attempt to establish a price above USD 0.50 per mscf for gas destined for power plants. An industry trade group representative leading the negotiations with NNPC told Econoff that if the IOCs can get a price above that level, government securitization on that price, and

concurrent guarantees that the GON will transfer to a market-based pricing then they can live with the policy "for a few years." The contact thought the policy would not last three years. When pressed he admitted that the IOCs were in essence "hunkering down" and waiting until the flaws in the policy became evident. Additionally, a representative from Nigeria Liquefied Natural Gas (NLNG) told Econcouns and Econoff that his organization could live with the policy and the IOCs have no choice but to accept it. (Note: NLNG already has supply contracts signed for its six LNG trains. It clearly feels confident that those contracts will be honored, even under the new policy. End Note.)

¶10. (C) The policy and regulation, with their caveats, contradictions, and vagueness, favor parties experienced in Nigerian backroom politics. For instance, in the implementing regulation, one of the powers given to the Minister of Gas is to "from time to time identify and prioritize specific export projects that have strategic impact on the development of the domestic gas market for consideration and inclusion in the Domestic Gas Demand Requirement." That single statement leaves the door open for any number of export LNG or pipeline projects to be given favorable transfer pricing treatment, providing the project backers can obtain the blessing of the Minister. Another article of the regulation gives the Minister the power to "review or amend, alter, add to or delete any provision of these regulations as he may deem fit" with the only requirement being to "consult" with "relevant stakeholders".

¶11. (C) Comment: The weaknesses in the policy will likely slow development of Nigeria's natural gas which is

unfortunate, not only for the world market, but for the Nigerian people; getting the gas policy right is critical for developing Nigeria's electricity generation, which is in turn critical for developing the country's non-oil economy. While established actors can wait it out, new entrants to the market may hesitate to make bold investments given the uncertainty in the policy and the knowledge it may change in a few years. Given the scale, expense, and long lead times required, natural gas projects demand, if nothing else, policy stability and consistency. On a bright note, this policy may give the USG an opportunity to engage the Nigerian government on a workable follow-on plan we anticipate will be needed to address the economic failure of this one. The UK has expressed an interest in engaging the GON on this issue and Norway already has a working relationship with the GON on a range of hydrocarbon issues. End Comment.

¶12. (U) This cable was cleared by Embassy Abuja.
BLAIR